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(U) This cable is sensitive but unclassified. Please protect accordingly.

¶1. (SBU) Summary. Cyprus continues to enjoy economic stability, even in the face of ongoing global financial turmoil. This prosperity will come under pressure in 2009, as construction and tourism slow in the face of reduced foreign demand. Against this background, the GOC announced an assistance package for the tourism and construction sectors, amounting to a paltry - according to the opposition - Euro 52 million. Cyprus is one of the few EU countries not considering a comprehensive rescue plan for its banks, reflecting the strength of this sector, concern that such a plan might lead observers to believe bank failure was imminent, and simple inertia. Various government departments and the banks are arguing whether or not the banks have a shortage of liquidity as they tighten lending. The situation is exacerbated by acrimony between Central Bank Governor Orphanides and Finance Minister Stavrakis. End Summary.

Economic Overview

¶2. (SBU) The Cypriot economy is still holding up remarkably well in the face of ongoing global financial turmoil. The growth rate for 2008 is estimated at 3.7 percent - twice the average EU rate. For 2009, the GOC predicts a growth rate of 3.0 percent although many private analysts expect more moderate growth of around 2.0 percent. As of Q3 of 2008, the economy was still growing at a pace of 0.6 percent over the previous quarter, according to a "flash" estimate from the Department of Statistics. This has been the slowest pace Cyprus has experienced in four years, with the deceleration attributed primarily to slowdowns in construction, hotel and restaurant services, and real estate.

¶3. (SBU) Things are expected to get worse in the construction and tourism sectors. Property sales, which had been soaring in recent years, recorded a 50 percent drop in October 2008, year-on-year. This decline has not yet been reflected in property prices, despite a meteoric rise in previous years. Values for residential property in Cyprus have increased from Euros 363 per square meter in 1992 to Euros 1,269 by the end of 2007. At the end of 3Q 2008, property values rose by just 1.5 percent over the previous quarter. The trend in the near future calls for a leveling off of property values, with a tendency to decline in 2009. However, no one is predicting a crash in property prices, largely due to the idiosyncrasies of the Cyprus property market. These include the tendency of domestic property buyers, who account for 80 percent of total demand, to hold on to their property for a long time; conservative lending practices in the mortgage industry; and a legal system requiring 5-7 years to foreclose on a property. In their worst-case scenario, most analysts see a price decline of up to 20 percent over the next one-two years although sales volume will continue to decline more than that.

¶4. (SBU) Tourism has historically been Cyprus' growth engine, but has been waning in importance over the last decade due to its eroding competitiveness (principally, sky-rocketing domestic labor costs, higher air fares, and lack of new investment.) Until the late Nineties, tourism contributed up to 22 percent of GDP. Its share is now down to 12-13 percent as construction and financial services comprise a greater proportion of the island's economic activity. The tourism outlook for next year is grim: bookings for the summer of 2009 are currently down 14 percent from 2008 and tourism receipts have declined 4.1 percent through the first nine months of this year with the decline accelerating in October.

The GOC Plan

¶5. (SBU) Until mid-November, the response of GOC officials towards the global financial crisis had been that Cyprus does not face any particular problems. In October, President Christofias said: "We do enjoy conditions of labor peace and economic stability over the past decades due to the fact that we followed a mixed system and have not adopted the call for deregulation in laissez-faire, that is a market economy ruled simply by the invisible hand." This sanguine attitude changed somewhat on November 14, when President Christofias, after meeting with his cabinet, announced a Euro 52 million plan to stimulate construction and tourism in the face of the international financial crisis. The plan includes a Euro 12 million grant to the (semi-government) Cyprus Tourism Organization (CTO) for additional tourism promotion abroad. The remaining Euro 40 million will be spent as follows:

-- Expediting implementation of key infrastructure projects included in the 2009 budget;
-- Strengthening government housing projects;

-- Simplifying the process of issuing a building license;

-- Providing municipalities with extra funding (in addition to funding included in the 2009 budget);

-- Providing incentives to hoteliers for hotel and general tourist infrastructure upgrades;

-- Simplifying the visa-issuing process for tourists from high interest markets (mainly from Eastern Europe); and

-- Establishing consular offices in key tourist markets.

¶6. (SBU) President Christofias described the measures as "pre-emptive" and reiterated that the Cypriot economy was, generally, still in a good shape. A couple of days later, Communications Minister Nicos Nicolaides also announced that the government was considering a drastic reduction in annual private vehicle registration fees. Details of the plan are still being worked out but the cut is estimated to be around Euros 40 million, up to half of the annual GOC revenue from car registration fees.

Public Reaction to Government Plan

¶7. (SBU) The private sector was umimpressed with the government's assistance plan. Haris Loizides, President of the Cyprus Hotel (Owners) Association commented that the much-anticipated measures fell short of the expectations of those involved in tourism: "The message we are hearing from the government is that it is up to the private sector to fend for itself." He added that he expected the GOC to do more for tourism, as the situation develops. Lakis Tofarides, President of the Cyprus Developers' Association, commented that his association had expected more help from the government, particularly by way of facilitating property purchases. He added that the government had seemingly ignored a list of measures suggested by the association. Tofarides pledged to pursue further meetings with the GOC on this issue.

¶8. (SBU) Opposition DISY Deputy Press Spokesman Haris Georgiades also expressed his party's disappointment at the measures, noting that these were too general and un-focused, failing to provide specific support to productive sectors. Specifically, he noted, DISY was hoping that the government would translate words into

action and would considerably upgrade development spending -he did not define what comprises "development spending." Georgiades also expressed serious doubt as the effectiveness of the measures to deal with the financial crisis.

Banking Sector Sound But Loans Harder to Find
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¶9. (SBU) Cypriot officials, from the President on down, have offered repeated assurances that the Cypriot economy is in a good shape and that, if worse came to worst, the state would not allow any Cypriot bank to fail. However, there remains no coherent plan for government action in case things suddenly deteriorate. Five weeks ago, Finance Minister Stavrakis announced that Cyprus would provide insurance for bank deposits of up to Euros 100,000 per depositor per bank, up from a previous maximum of Euros 20,000. The deposit insurance scheme will be funded exclusively by banks with no ROC assets involved. The bill to implement this decision has not yet received Parliament's approval as its mechanics (i.e. how much each bank will pay, and when) are still being worked out and the banks are balking at carrying the entire cost. Because the Finance Minister implied the government would provide this insurance, and since the banks remain in apparent financial health, there has been no outflow of deposits from Cyprus banks despite the lack of the actual implementing legislation.

¶10. (SBU) The only other measure the ROC has considered for helping the banking sector has been finding ways to increase bank liquidity. The loans-to-deposits ratio has increased steadily over the last two years, from 72 percent in January 2007 to 92 percent in September ¶2008. This was on the back of several of years of sizzling growth in total lending, which reached a 37.5 percent increase in September 2008 year-on-year. New loan volume declined dramatically in October as banks increased their lending standards and their pricing as deposit growth slowed. Businessmen are complaining they are cash-strapped, and that tight lending is hurting their businesses and the economy. Auto dealers tell us that their sales declined by up to 50 percent last month as customers couldn't find loans except or only at high rates. The construction sector is anticipating a 30 -40 percent decline in revenue for 2009 and plans to lay off almost half of its 45,000 workers despite the GOC's stimulus plan.

Hefty Deposits That Banks Can't Use

¶11. (SBU) According to the European Central Bank, total lending in Cyprus reached 231.0 percent of GDP in September 2008, from 180.5 percent in September 2005 (and compared to a Eurozone average of 123.5 percent). Over the same period, total deposits in Cyprus (excluding deposits from third countries) reached 219.0 percent of GDP in September 2008, from 191.7 percent in September 2005 (and compared to a Eurozone average of 104.8 percent). If deposits from third countries are counted, the ratio of total deposits to GDP improves to 279.2 percent. However, Cypriot banks are not allowed to lend more than 30 percent of their non-Euro deposits received from third countries. The Central Bank requires local banks to maintain 70 percent of such deposits in reserves (down from 75 percent at the beginning of this year). Cypriot banks have been pressuring the Central Bank (and the government) to reduce the foreign currency reserve requirement by 10-20 percentage points to inject more liquidity in the system so that banks could lend more easily. So far, the Central Bank has steadfastly blocked such efforts, fearing it might endanger the stability of the system, in case there is a run by foreign depositors. The biggest structural weakness in the banking system is that 25 percent of all Cyprus bank deposits are from Russia, or companies formed to do business in Russia, and denominated largely in US$. Any significant decline in these deposits would result in a severe liquidity crisis for the banking system.

Central Bank vs. Finance Ministry

¶12. (SBU) The government has been sympathetic to the banks' request but has done little more than apply political pressure on the Central Bank to reduce the liquidity requirement. This has further aggravated already tense relations between Central Bank Governor Orphanides and Finance Minister Stavrakis. Several months ago, the

Ministry of Finance pressured the Central Bank to sell off part of its gold reserves to "take advantage of high gold prices," meeting with the Central Bank's outright refusal to be told what it should do with its reserves and forcefully noting that it is an independent body. This exacerbated government mistrust of the Bank Governor and his "neo-liberal" approach (learned from his 19-year career at the US Federal Reserve.)

¶13. (SBU) Some analysts believe that the reduction in new bank lending is more of a pricing issue than a liquidity shortage. New banks entered the market over the past year and began offering above-market rates to win market share. The result has been a deposit interest rate war amongst banks - with rates currently reaching 6.5 percent for sizeable (over Euro 50,000) fixed-term deposits. With many recent loan rates tied to the ECB refinancing rate, currently at 3.25 percent, pressure on bank Net Interest Margins has been building.

¶14. (SBU) Comment: While the economy slows and banks tighten their lending practices, consumer and business confidence is not helped by the ongoing personal rivalry between Orphanides and Stavrakis -- arguably, the two most important players for the Cypriot economy. Regardless of the merits of each side's arguments, the current acrimony helps no one, particularly at such a dangerous juncture for the Cypriot economy.

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